

Sept 19, 2000

# Presentation to the Subcommittee on Domestic and International Monetary Policy

"The Future of Electronic Payments: Roadblocks and Emerging  
Practices"

In 1997, we wrote a report entitled "The Sleeping Bear Awakens" in which we described the potential for technology companies, banks and payment networks to develop a payment infrastructure suitable for the 21<sup>st</sup> century. Some of the predictions and postulations we made in that report have proven reasonably accurate while in other cases, we somewhat missed the point.

We realized that an electronic economy, one unquestionably subsuming the physical economy by the day, would by necessity require an efficient electronic payment network. This network must be efficient in not only payment settlement, but also in payment message management. We argued that new information delivery networks would be necessary and the private economy would likely deliver the necessary technology, financing, services and intellectual capital to make it happen.

At the same time, we also felt that current payment networks, particularly the ACH, ATM, credit card and Fedwire networks, would experience rapid transaction growth contemporaneous with the anticipated acceleration in electronic payments. In effect, we reasoned that the existing US payments infrastructure would work just fine but that a new set of virtual messaging networks would likely be necessary.

We indeed see today the development of such messaging networks and they are thriving in the private economy. Where we may have missed an essential point in the original research was in the potential to satisfy the need, for alternative self-clearing organizations that could offer a better cost/value proposition compared to the traditional alternatives.

Stepping back, and with some three years additional insight, we now see why some of the existing payment networks, particularly the most popular one today on the Internet – credit cards – may not do the trick.

First and foremost is cost. Today, in a credit card transaction, a merchant pays an average of 250-300 basis points (2-3%) of the total transaction for credit card payment services. Most merchants operate at profit margins falling below these levels. Second, card network rules are rather draconian and biased against the merchant. Third, the information flows are loosely connected, disjointed and slow. Fourth, there are arguably too many redundant steps in the value chain and this adds to the inherent cost. Fifth, there is no properly functioning authentication system.

We can perhaps use the challenges the credit card networks face in the 21<sup>st</sup> century as a stepping stone to the broader issue at hand: how do banks remain in the game and how does an otherwise viable and valuable payment network adapt?

First, regulatory adaptation. Today, a merchant is completely uninsured in the event of a customer chargeback or dispute. With no way to authenticate the customer prior to the transaction, and with no written authorization, the customer can easily repudiate the transaction. In many legitimate industries, chargeback rates exceed 30%. Merchants likely will look to viable alternatives when they appear. And these alternatives will likely include on-us settlement within a single settlement agent, efficient and effective authentication and rapid and robust information reporting services.

Second, encourage the development of alternative economic arrangements. In a credit card transaction, a merchant acquirer which is usually fronted by an Internet



payment gateway serves the merchant. The acquirer, in turn, serves a merchant bank settlement agent and at the same time, connects to the card-issuing bank through the card networks for authorization. These arrangements worked effectively in the physical world. Yet the Internet is a network and only two parties are necessary to do the trick – a settlement bank and a customer service/information manager. Instead of working along these lines, the card networks attempted through an initiative called Secure Electronic Transaction or SET to foist the existing structure onto the Internet. It simply has not worked.

Third, develop an efficient and economically viable authentication system. Here, banks by necessity must work with private industry to develop the necessary authentication prior to the initiation of settlement. We don't believe the card associations have encouraged industry enough to find a solution to this problem.

In sum, the development of self-clearing organizations will occur due to the inherent weaknesses in our existing payment's networks like those in the credit card networks. Such developments will require very careful examination by us as industry observers as well as citizens concerned about the health of the financial economy. The developments we have seen thus far have occurred in close cooperation with the banking industry as well as the established payment networks. Thus, an Internet non-depository organization that works with a bank partner which acts as its on-ramp into the existing payment networks represents a harmonious solution particularly given the increasing needs of the Internet economy.

And with that, I will thank you for inviting me to present to your committee Mr. Chairman and take any question the committee may have.

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